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BEFORE THE ARIZONA CORPORATION COMMISSION

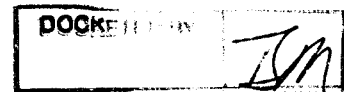
IN THE MATTER OF THE APPLICATION  
OF ARIZONA WATER COMPANY, AN  
ARIZONA CORPORATION, FOR A  
DETERMINATION OF THE FAIR VALUE  
OF ITS UTILITY PLANT AND PROPERTY,  
AND FOR ADJUSTMENTS TO ITS RATES  
AND CHARGES FOR UTILITY SERVICE  
FURNISHED BY ITS EASTERN GROUP  
AND FOR CERTAIN RELATED  
APPROVALS.

DOCKET NO. W-01445A-11-0310

Arizona Corporation Commission

DOCKETED

JUN 06 2013



**ARIZONA WATER COMPANY'S  
EXCEPTIONS TO RECOMMENDED OPINION AND ORDER  
(SEPARATE PHASE 2 PROCEEDINGS)**

Pursuant to A.A.C. R14-3-110(B), Arizona Water Company respectfully submits the following exceptions to the Recommended Opinion and Order ("ROO") issued on May 28, 2013. Arizona Water Company takes exception to only one aspect of the ROO: instead of approving or denying the Settlement Agreement signed and supported by the Arizona Corporation Commission Utilities Division ("Staff"), Arizona Water Company and the other water and wastewater utility intervenors, the ROO seeks to impose on Arizona Water Company a punitive, unsupported and improper reduction to the general rate case return on equity ("ROE"), from the 10.55 percent the Commission authorized in Decision No. 73736 dated February 20, 2013 to 10.00 percent, as the "price" of the adoption of a SIB mechanism.

**I. Lowering the ROE Constitutes An Improper Amendment And Partial Rescission Of Decision No. 73736 in Violation of A.R.S. § 40-252.**

The Commission unanimously approved Decision No. 73736 following a fully contested rate case concerning Arizona Water Company's Eastern Group of systems on February 20, 2013. The Commission authorized the Company an ROE of 10.55 percent in that Decision. At the Open Meeting on February 12, 2013 at which Decision No. 73736 was discussed, despite discussion concerning any relationship between ROE and a distribution system improvement charge ("DSIC")-like mechanism, the Commission neither proposed nor adopted an adjustment to Arizona Water Company's ROE. After the Commission approved the Decision on February 20, under A.R.S. § 40-253, any party to the action—including the Residential Utility Consumer Office ("RUCO")—had 20 days to apply for a rehearing of any matter determined in that action, including the authorized ROE. No party did so, and the Commission did not order a rehearing of that Decision on its own accord in a Procedural Order or otherwise. To the contrary, in the portion of Decision No. 73736 establishing Phase 2 of this proceeding, the Commission explicitly provided an opportunity for late intervention solely "for the specific and limited purpose of participating in proceedings addressing [Arizona Water Company]'s DSIC proposal, other DSIC-like proposals, and the possibility of achieving a settlement/compromise on the two." (Decision No. 73736, Findings of Fact ¶ 34 at pp. 110-111). In the relevant Ordering paragraph of the Decision, the Commission similarly permitted late intervention solely for review of DSIC or DSIC-like proposals, with no mention of any reconsideration or rehearing of the ROE issue. (Id. at p. 113, ll. 17-20). When the 20-day rehearing deadline set forth in A.R.S. § 40-253 passed on March 12, 2013, Decision No. 73736 became final in every respect as a matter of law.

A.R.S. § 40-252 states the narrow circumstances under which a Commission final decision and order such as Decision No. 73736 can be rescinded, altered or amended:

**Rescission or amendment of orders by commission; collateral attack on final orders or decisions prohibited**

1 The commission may at any time, upon notice to the corporation affected, and  
2 after opportunity to be heard as upon a complaint, rescind, alter or amend any  
3 order or decision made by it. When the order making such rescission,  
4 alteration or amendment is served upon the corporation affected, it is effective  
5 as an original order or decision. In all collateral actions or proceedings, the  
6 orders and decisions of the commission which have become final shall be  
7 conclusive.

8 In the subsequent Phase 2 proceeding that now forms the basis of the ROO, RUCO  
9 did not seek to include a reduction in Arizona Water Company's Commission-approved  
10 Eastern Group ROE. Additionally, neither RUCO, the Company nor any other party did  
11 anything to trigger an alteration or amendment of Decision No. 73736, as required in A.R.S.  
12 § 40-253. No aspect of that Decision was noticed for rehearing, and in Phase 2 the parties  
13 proceeded to negotiate a settlement agreement with the terms, conditions, processes, and  
14 provisions for a DSIC-like mechanism on the basis that the Commission-adopted ROE of  
15 10.55 percent set in the Decision was beyond collateral attack and established with finality,  
16 as it was legal in every respect. No evidence was offered by any party as to how or on what  
17 basis to reduce the Commission-adopted ROE for the Eastern Group which was based on  
18 the evidence presented in that case. A 55-basis point reduction to the already adopted  
19 general rate case ROE cannot stand as a matter of law where a proceeding to address a  
20 change in the ROE approved by the Commission in Decision No. 73736 was never noticed  
21 as required by A.R.S. § 40-252. See *Timmerman v. Lightning Moving & Warehouse Co.*, 83  
22 Ariz. 398, 322 P.2d 376 (1958)(Arizona Supreme Court reversing a Commission Order  
23 entered after a prior contrary ruling had become final and was not appealed, holding the  
24 prior ruling had become *res judicata* and that "there existed no legal method under the law"  
25 by which the Commission could reverse the prior ruling. *Id.* at 403, 322 P.2d at 381).

26 Here, as the Commission expressly stated, the sole issue in Phase 2, which is  
27 procedurally a separate proceeding that will be the subject of a separate Decision and Order,  
28 was the SIB mechanism and the parties' Settlement Agreement to implement it, which is  
addressed elsewhere in the ROO. Consequently, A.R.S. § 40-252 and Arizona law preclude  
an adjustment to the ROE in Decision No. 73736.

1     **II.     A 55 Basis Point Reduction To ROE Is Punitive and Negates The Benefits**  
2     **Afforded by the Negotiated SIB Mechanism.**

3     The ROO's unilateral lowering of Arizona Water Company's Commission-approved  
4     ROE from 10.55 to 10.00 percent is not only legally improper, but it also imposes a material  
5     and unacceptable change to the parties' Settlement Agreement. Lowering Arizona Water  
6     Company's earnings by this amount sends a chilling message to investors at the very time  
7     when it is faced with the need to replace significant amounts of aging and failing  
8     infrastructure and negates the primary benefits of the negotiated SIB mechanism - the  
9     incentive to invest in the replacement of such aging and failing infrastructure in a way that  
10    allows for gradual revenue increases instead of rate shock. The reduced cash flow caused  
11    by a reduction in ROE would greatly inhibit Arizona Water Company's ability to attract  
12    capital and reduce the amount of funds available to make qualifying infrastructure  
13    replacements prior to filing for partial cost recovery under the negotiated SIB mechanism  
14    set forth in the parties' Settlement Agreement, thereby effectively eliminating the SIB  
15    mechanism benefits.

16    Moreover, the ROE reduction proposed in the ROO applies to *all* of Arizona Water  
17    Company's Eastern Group utility plant and significantly reduces the cash flow associated  
18    with utility assets that have been in service for years, in exchange for the prospect of  
19    reducing the regulatory lag associated with limited, qualifying infrastructure replacements  
20    that have yet to be made.

21    To apply a broad ROE reduction across the board to all utility plant bears no  
22    relationship to risks allegedly reduced under such a mechanism. In contrast, the negotiated  
23    SIB mechanism appropriately applies its five percent Efficiency Credit only to SIB-eligible  
24    replacements. The Signatory Parties—including Arizona Water Company, Commission  
25    Staff and all of the intervenors save for RUCO—agreed that the quid pro quo for the  
26    opportunity to reduce the regulatory lag associated with such limited, qualifying future  
27    infrastructure replacements would be in the form of the Efficiency Credit, which translates  
28    to an already agreed-upon *87-basis point reduction to the ROE* on SIB-eligible  
  replacements.

1 **III. There is No Evidence In This Record To Support the Additional Sweeping 55-**  
2 **Basis Point Reduction To the General Rate Case ROE.**

3 In the Phase 2 hearing, no one (and certainly not the Signatory Parties) presented  
4 evidence justifying any specific reduction to the ROE the Commission authorized for  
5 Arizona Water Company's Eastern Group of systems.<sup>1</sup> In fact, the only competent evidence  
6 in the record is that the SIB mechanism as negotiated by the Signatory Parties does not  
7 justify *any* reduction to the Commission-authorized ROE in its general rate case decision.  
8 Utilities Division Director Steve Olea addressed the issue as follows:

9 [W]hat we're saying is, for Arizona Water's 10.55, you don't have to  
10 look at that, the way the SIB is set up with the efficiency credit. If you set up  
11 the SIB the same way for other companies, then those two items will be  
12 separate. The ROE would be separate from the SIB, because you've already  
13 taken something in account.

14 \* \* \*

15 Q. [By Counsel for RUCO]: So as we move forward, Mr. Olea,  
16 and we look at SIB surcharge applications in the future, is it your testimony  
17 that as long as there's an efficiency credit, then Staff will be – Staff won't  
18 concern itself with the return on equity as it relates to the investment issue?

19 A. That's what I'm saying.

20 \* \* \*

21 Q. Do you believe, to the extent that the 5 percent efficiency credit  
22 is a benefit to ratepayers, that the benefit is negated by the higher 10.55  
23 percent ROE awarded by the Commission?

24 A. No.

25 Q. Why not?

26 A. Because I think that the risk is what the risk is on that company,  
27 and the fact that they now have a mechanism or would have a mechanism to  
28

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1 <sup>1</sup> RUCO presented no evidence whatsoever about how or to what extent to adjust ROE  
2 because of the SIB mechanism, a fact that was confirmed both by Mr. Quinn [Phase 2  
3 Transcript "P-2 Tr." at p. 427, ll. 14-19] and Mr. Rigsby [*Id.* at p. 487, ll. 16-20; p. 488, l. 6  
4 – p. 489, l. 1], and presented no studies to support its theory about reduction to ROE where  
5 there was a DSIC-type mechanism. [*Id.* at p. 489, ll. 2-7].

1 address part of that, you know, part of their infrastructure needs, doesn't  
2 change that. That risk still is what it is.

3 Q. Do you think the company's ROE in this case should be a  
4 consideration when evaluating the SIB?

5 A. No. As I stated earlier, as long as you have some type of credit  
6 in their in the SIB, then no. If you didn't have that, which is why I totally  
7 agree with the way the ROO was written, it says that the DSIC that the  
8 company had, and that's why they didn't get the DSIC.

9 [P-2 Tr. at p. 272, ll. 12-18; p. 272, l. 23 – p. 273, l. 3; p. 275, l. 23 – p. 276, l. 15].

10 Mr. Olea also addressed specific Commissioner questions on this point that were  
11 posed to him by ALJ Nodes:

12 Q. [By Judge Nodes] And the final question from Commissioner  
13 Burns' office is, if in a rate case the cost of equity incorporates investor risk,  
14 then wouldn't the inclusion of a DSIC-type mechanism for the purpose of rate  
15 gradualism mitigate some of that risk?

16 A. Can you say that again?

17 Q. I think she means if a DSIC is granted for purposes of rate  
18 gradualism, would the approval of such a mechanism mitigate some of the, I  
19 suppose, financial risk that is associated with whatever position that company  
20 is in?

21 A. And I think my answer to that would be, is that the way that we  
22 have set up with SIB with the efficiency credit and with all of the protections  
23 in here to make sure that it's only plant that really needs to be replaced, with  
24 all the checks in it, and because the amount of plant that's being replaced,  
25 especially in the case of Arizona Water Company, is very small compared to  
26 their total plant, then I think, as I stated earlier, that really shouldn't come into  
27 play with the ROE. The ROE is set up on, you know, whatever the risk is, and  
28 the SIB is separate in Staff's mind.

I know that as far as tying any type of DSIC mechanism to ROE, that  
has been the argument from the day one since DSIC has first been done in  
Pennsylvania, which was quite a few years ago. And as far as I know, I think  
the SIB is the only one that I know of that I've read about, and, you know, I  
don't, obviously, know all the DSIC mechanisms in all the states, but the SIB  
is the only one that has this kind of – some kind of credit in it for the

1 customers, and that's the one thing Staff was really pushing for that was  
2 different from the DSIC that was filed by Arizona Water.

3 Q. But in your mind, even though the Commission specifically  
4 indicated that it was granting a higher ROE than it might otherwise have  
5 granted due to the infrastructure replacement needs that had been identified  
6 during the case, you don't believe that there should be any lowering of the  
7 ROE in this case given the fact that you're now recommending a SIB  
8 mechanism be approved, which seemingly is intended to recognize the same  
9 type of infrastructure replacement needs?

10 A. Correct, we are not recommending that the ROE be changed  
11 from what's in the order that's out there now, even with the SIB.

12 [Id. at p. 317, l. 13 – p. 319, l. 7]. Mr. Olea also testified that he was unaware of any  
13 instances where the Commission has ever *increased* an ROE to account for actions it took  
14 that resulted in *worsening* the effects of regulatory lag, such as elimination of purchased  
15 power adjustors or purchased water adjusters. [Id. at p. 349, l.25 – p. 350, l. 15].

16 As its sole support for its proposed 55-basis point reduction to ROE, the ROO relies  
17 on a 2012 *settlement* in Arizona Water Company's Western Group rate case (Decision No.  
18 73144 dated May 1, 2012) and a *proposed settlement* with a compromise 10.00 percent  
19 ROE in the pending Northern Group rate case that concluded hearings in May 2013 and has  
20 not even been briefed, yet alone decided, by the Commission. Both of these settlements and  
21 compromises were the product of extensive give-and-take negotiations over a wide range of  
22 issues related to different systems, in different parts of the State, involving different parties  
23 at different times with different circumstances affecting utility service. It is inappropriate  
24 for the Commission to "cherry pick" bits and pieces of heavily-negotiated past or yet to be  
25 decided settlement agreements and then to employ those factors in isolation—without  
26 knowing what was given up in exchange for a particular compromise—in an attempt to  
27 justify a result in a different case involving a different system. A party should be  
28 comfortable in offering a compromise of a position in the interest of settlement without fear  
that those concessions will later be cited as precedent and authority against them in  
unrelated proceedings.

Moreover, the isolated portions of previous compromises as to ROE are expressly inadmissible as evidence in subsequent proceedings under Rule 408, *Arizona Rules of Evidence*. This rule is applicable in this case under A.A.C. R14-3-109(K), and the substantive use of this information is not merely “technical.” Under Rule 408, evidence of “accepting, promising to accept or offering to accept” a consideration in compromising a claim, as well as “conduct or a statement made during compromise negotiations about the claim” are “not admissible—on behalf of any party—either to prove or disprove the validity or amount of a disputed claim or to impeach by a prior inconsistent statement or a contradiction.” *Id.* Here the ROO specifically adopts as the sole basis for its proposed ROE reduction a compromise that was approved by the Commission in a prior unrelated case and offered, but not yet approved, in another pending case that is still under consideration. The public policy behind the rule is clear and directly applicable to the ROO—it is impossible to extract the related compromises and weigh the considerations that led to the agreement to the lower settled ROE rate in those cases, and to simply strip the compromised rate out of the context of the settlement and apply it “to prove the validity or amount of a disputed claim” or “to impeach by a prior inconsistent statement or a contradiction” is a direct violation of Rule 408. Such evidence is barred from introduction or use in subsequent proceedings for purposes of establishing an amount of liability. *See Banker v. Nighswander, Martin & Mitchell*, 37 F.3d 866 (2d Cir. 1994)(vacating judgment providing for reduction of damages to \$50,000 based on the fact that that the plaintiff had agreed to settle the case at one point at about that amount and holding that Rule 408 “bars the introduction of a settlement offer for the purpose of proving the amount of a liability. No other explanation for the \$50,000 award is apparent from the record, and therefore we lack the findings necessary to affirm the damage award.” *Id.* at 872.)

**IV. The ROO’s Proposed Reduction in ROE, If Adopted, Would Be A Material Change In the Settlement Agreement Triggering Arizona Water Company’s Withdrawal From the Settlement.**

A centerpiece of the Settlement Agreement reached by the parties following the February 12, 2013 Open Meeting was the avowal that “Nothing herein is intended to amend



1 or supersede Decision No. 73736, which Decision is final in every respect.” (Settlement  
2 Agreement, ROO Attachment A, at § 11.1). The Signatory Parties further agreed that if the  
3 Commission failed to adopt all material terms in the Settlement Agreement, or added new or  
4 different material terms to it, any party could withdraw from the settlement and be free to  
5 pursue their own remedies at law. (*Id.* at § 11.6). There is no doubt that the monetary  
6 impact of the additional 55 basis point reduction to the ROE the Commission already  
7 approved in Decision No. 73736 is a material change in the terms of the Settlement  
8 Agreement reached by the Signatory Parties, in that it negates the benefits of the SIB  
9 mechanism the Signatory Parties carefully negotiated and adopted in the Settlement  
0 Agreement and directly and drastically (and improperly) “amends and supersedes” Decision  
1 No. 73736. Although Arizona Water Company supported the SIB mechanism concept and  
2 entered into numerous good faith compromises to reach agreement with Staff and  
3 intervenors (including the 87-basis point reduction in ROE as part of the agreed-upon  
4 Efficiency Credit to customers), it never contemplated that the cost to seek a reduction in  
5 regulatory lag associated with limited future infrastructure replacements would be over a  
6 million dollars in lost revenue over the current rate case cycle.<sup>2</sup> Therefore, if the  
7 Commission were to adopt the ROO with the sections reducing the general rate case ROE to  
8 10.00 percent, Arizona Water Company would have no choice but to withdraw from the  
19 Settlement Agreement and seek its legal remedies to restore the provisions the Commission  
20 already decided and approved in Decision No. 73736.

21 **V. Conclusion.**

22 The Commission should approve the Settlement Agreement and adopt the ROO  
23 without the sections that propose lowering its already approved ROE by an additional 55-


24 <sup>2</sup> Based on a 55-basis point reduction in ROE, the assumption that rates in the Eastern  
25 Group’s next general rate case would go into effect in August 2017 (based on the Settlement  
26 Agreement’s requirement to file a general rate case by August 31, 2016), and the following  
27 ratemaking elements approved in Decision No. 73736: total Eastern Group rate base of  
\$63,253,911; an equity ratio of 50.97%, and; a gross revenue conversion factor of 1.6576:

28 
$$[(((\$63,253,911 \times 50.97\%) \times 0.55\%) \times 1.6576) \times 4 \text{ years}] = \$1,175,721$$

1 basis points beyond the agreed-upon 87-basis point reduction in ROE applicable to all SIB-  
2 eligible and approved water infrastructure replacements. Alternatively, the ROO should be  
3 rejected *in toto*, Phase 2 closed, and Decision No. 73736 left standing unamended.

4 RESPECTFULLY SUBMITTED this 6th day of June, 2013.

5 BRYAN CAVE LLP

6  
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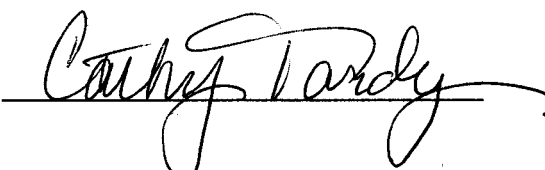
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